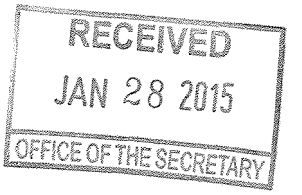
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15873

In the Matter of

THOMAS R. DELANEY II and
CHARLES W. YANCEY

Respondents.

RESPONDENT THOMAS R. DELANEY II'S RESPONSE TO ORDER DATED JANUARY 23, 2015

INTRODUCTION

For the first time in the case, after the conclusion of the Final Hearing, the Division of Enforcement (the "Division") used its post-hearing briefing to advance theories of negligence and recklessness against Delaney. On January 23, 2015, this Court issued an Order permitting Delaney "to identify, with specificity, any and all additional evidence that he would have otherwise presented to defend himself on the issue of negligence." Because (1) the Order Instituting Proceedings (the "OIP") in this matter did not allege negligence as a basis for liability, (2) the Division did not in its Pre-Hearing Brief give any indication it would argue negligence, (3) the Division did not argue negligence as a basis for liability in any pre-hearing filing, (4) the Division did not argue negligence as a basis for liability in its opening argument, and (5) the Division did not even say the word negligence one time during the Final Hearing, much less argue it as a basis for liability, basing liability on negligence would violate Delaney's due process rights, the Administrative Procedures Act, and the SEC Rules of Practice.

Nevertheless, pursuant to the Court's Order, Delaney will provide a list of the numerous instances within the Final Hearing where cross examination would have proceeded differently, expert testimony would have been developed and presented differently, and additional evidence would have been offered.

ARGUMENT

I. Applicable Law.

Constitutional due process rights have been incorporated into SEC administrative proceedings through the Administrative Procedure Act and the SEC Rules of Practice. They require that a respondent in an administrative proceeding receive notice of an agency hearing

must "be timely informed of . . . the matters of fact and law asserted."[1] In addition, Sections 15(b) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act—the provisions under which the Commission initiated this action—require both notice and *an opportunity for a hearing* before any remedies can be imposed. These requirements are, in part, intended to ensure that respondents are sufficiently informed of the charges against them so they can prepare a defense.[2]

II. The Division Did Not Pursue Negligence or Recklessness as a Basis for Liability Until Post-Hearing Briefing.

A. The Division's Pre-Hearing Written Filings Do Not Pursue Negligence or Reckless Theories of Liability Against Delaney.

In its OIP, the Division alleged that Delaney willfully aided and abetted and caused PFSI to violate Rule 204T(a)/204(a). The Division did not, however, include any substantive allegations to indicate that it believed Delaney could or should be liable for negligently causing or recklessly aiding and abetting the violations, sufficient to put Delaney on notice of these theories.[3] For that matter, the Division also gave no indication it was pursuing a pure causing claim (based on negligence) that is divorced from its aiding and abetting claim.

Moreover, the Division did not argue negligence or recklessness as a basis for liability in the testimony of the Division's experts, in its pre-hearing briefing, in its opening statements, or

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[1] 5 U.S.C. § 554(b)(3) (1994); see also, *See* Rule 200(b)(3), ("the order shall set forth the factual and legal basis alleged therefor in such detail as will permit a specific response thereto.")

[2] *See In Matter of optionsXpress, Inc.,* Release No. 710, 104 S.E.C. 419, 2012 WL 8704501 at *2 (July 11, 2012). The Division recognized this principle in its Memorandum in Opposition to Delaney's Motion for More Definite Statement, p. 1.

[3] As Delaney indicated in his post-hearing briefing, and re-affirms here, the Division pursued only a theory of intentional misconduct against Delaney until its Post-Hearing Brief. This is readily apparent from the allegations in the OIP and all of its pre-hearing filings. For example, the Division's Response to Delaney's Motion for More Definite Statement did not reference either negligence or recklessness, but rather stated "[t]he OIP further details Delaney's intentional misconduct, which included his knowledge of Stock Loan's practice and his hiding the practice from regulators." (*Id.,* p. 2) Similarly, the Division's Pre-Hearing Brief is devoid of any theory but intentional misconduct.

in its closing statements.[4] Indeed, neither the word negligent nor any of its permutations appears anywhere in the transcript of the Final Hearing.[5]

Although the Court observes that "Delaney apparently had the opportunity to present and argue the evidence that he believes would have disproven negligence liability," the Division's filings in this case, which did not mention negligence, eliminated any reasonable basis Delaney would have had to introduce evidence that dealt only with a defense to an unalleged claim of negligence. For example, Delaney's Pre-Hearing Brief was due and was filed on the same day as the Division's. Thus, the language quoted by the Court to establish that Delaney had some basis to introduce evidence of negligence was merely anticipating arguments the Division might make in its opening brief.

But, Delaney's speculation about what theories the Division might advance was contradicted by what the Division actually did argue in its simultaneously-filed Pre-Hearing Brief. In the Division's Pre-Hearing Brief, the only legal theory of liability offered against Delaney was "The Standard for Aiding and Abetting."[6] There was no discussion of negligence as a basis for liability, no reference to "causing," and no recitation of the legal standard applicable to claims of negligence. Delaney did not know then, and still does not know, what theory of negligence the Division is asserting. Simply put, the Division effectively abandoned any separate claim it might have asserted for causing based on negligence prior to the Final

[4] The Court's Order observes that "there are at least two paragraphs in the OIP in which recklessness is explicitly alleged." However, neither of those references (and there are only two, not more as the Court's order might suggest in its use of the phrase "at least") gives notice that recklessness would or even might be the basis for liability. Rather in both cases the OIP alleges only that if Delaney did not know certain statements were false he was reckless in regard to their accuracy. No reasonable reading of these paragraphs of the OIP would have informed Delaney that he may be found liable based on a theory of recklessness. All of the Division's pre-hearing filings lead to the opposite conclusion. Thus, neither recklessness nor negligence should be considered for the same reasons.

[5] This assertion is based on a review of the transcript word indices, and an electronic key word search using the Adobe Acrobat word search function.

[6] Division's Pre-Hearing Brief at 18.

Hearing, thereby eliminating any incentive for Delaney to present evidence on this issue during the hearing. For example, Delaney responded to this action by the Division by, among other things, withdrawing the testimony of the only expert in the case who even partially articulated a standard of care for Chief Compliance Officers ("CCO").

Similarly the Division's failure to mention negligence once during the Final Hearing – not during the opening statement, the testimony of any witness including expert witnesses, or the closing argument – validated Delaney's decision not to advance a defense to a negligence claim.

Indeed, the Division so thoroughly abandoned the negligence theory that Delaney offered the following stipulation at the stipulation conference: "The Division of Enforcement is not pursuing a claim against Delaney for causing PFSI to violate Rule 204(a) that is independent of its chain for aiding and abetting violations." Final Hearing at 2482:4-8. In response, the Division explained that, "Your Honor, the case law is that aiding and abetting -- proving aiding and abetting is proving causing. We haven't abandoned our causing claim, and we don't intend to provide -- to present separate evidence of causing." *Id.* at 9-13. Division counsel itself thus acknowledged it was not advancing a separate causing claim, but rather only a derivative of its aiding and abetting claim, under the principle that a finding of aiding and abetting also necessarily makes that person a "cause" of those violations.[7]

Where the Division did not address negligence at any point prior to or during the Final Hearing, it is too late to pursue the theory now, notwithstanding the Court's request that Delaney now identify any and all evidence that he would otherwise have presented on the issue of negligence. As indicated, Delaney is entitled to notice and an opportunity for a hearing on a charge before liability or remedies may be imposed, including the right to "be ***timely informed*** of . . . the matters of fact ***and law*** asserted" in the proceeding against him, in order to allow him to

[7] The Division presented this principle as its Proposed Conclusion of Law 14, which Delaney did not dispute.

prepare a defense. Imposing liability based on the consideration of evidence not introduced at the hearing, or upon theories of liability neither pled nor pursued until post-hearing briefing, is inimical to these rights.[8] Indeed, as a result of the Division's hide-the-ball tactics, Delaney is now being asked to undertake the burden to first identify evidence that disproves a negligence theory not yet pled or described by the Division. This burden shifting is not permissible.

As observed by the Second Circuit in refusing to let the SEC belatedly shift theories:

> The SEC ultimately succumbs to its strategic choice at trial to pursue a theory of scienter or nothing. Its entire jury presentation was premised on the idea that O'Meally violated Section 17(a) through intentional conduct. The SEC's summation relied solely on intent and recklessness; theories rejected by the jury. And as to negligence, the SEC never introduced testimony or any other evidence on the appropriate standard of care against which a jury could measure O'Meally's conduct. "[T]he SEC's failure to present any evidence that [the defendant] violated an applicable standard of reasonable care was fatal to its case."
>
> The SEC argues on appeal that it always meant to pursue a negligence theory. The Commission points to stray references about negligence in the parties' joint pretrial statement and the jury charge; and the complaint alleges violations of Sections 17(a)(2)-(3), which can be proven without scienter. Pleadings aside, given the "complete and utter failure of proof by the Commission," the "jury's findings could only have been the result of sheer surmise and conjecture."

SEC v. Ginder, 752 F.3d 569, 576 (2d Cir. 2014) (citations omitted).[9]

B. The Division Failed to Offer Expert Testimony on the Standard of Care.

Delaney did not offer expert testimony on the issue of negligence. The Division did not offer expert testimony of the standard of care either. This is fatal to their negligence theory.

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[8] These same principles preclude the Division's belated effort to switch to recklessness.

[9] The *Aloha* case cited by the Court dealt with a distinct situation. In *Aloha*, the legal conclusion at issue was based on an undisputed factual record. *See Aloha Airlines, Inc. v. Civil Aeronautics Bd.*, 598 F.2d 250, 262 (D.C. Cir. 1979). By contrast, here, any facts underlying either negligence or recklessness are sharply disputed. Delaney was entitled to notice of these theories before the hearing, in order to develop a factual record to support his defenses.

In professional malpractice cases where the standards of care are not within the knowledge of the ordinary juror or judge, expert testimony is typically required to prove the standard of care or a departure therefrom. An allegation by the SEC that a defendant "failed to respond properly to 'red flags' does require proof through expert testimony."[10] Delaney thus objects to the Court considering negligence as a basis for liability in this matter.

III. The Evidence That Would Have Been Offered To Rebut Negligence.

Notwithstanding the foregoing, the Court's Order asks Delaney to "identify, with specificity, any and all additional evidence that he would have otherwise presented to defend himself on the issue of negligence." However, providing a thorough response to this request is made difficult, if not impossible, by the Division's failure to articulate a negligence theory—beyond its cursory assertion in its Post-Hearing Brief that the acts that constitute recklessness also constitute negligence—and its failure to apply the facts to this theory.[11] Thus, this exercise is one in which Delaney will have to guess at what theory of negligence Delaney is being asked to rebut. Had Delaney been given sufficient notice of the Division's negligence theory, more than the four days provided under the Court's Order, Delaney could have considered additional evidence. At the very least, had the Division informed Delaney of its intent to rely on a negligence theory, the evidence would have been different in at least the following ways. Delaney would have: (a) offered expert testimony on the issue; (b) cross-examined witnesses

[10] *SEC v. Badian*, 2010 U.S. Dist. LEXIS 123990, 8, 2010 WL 4840063 (S.D.N.Y. Nov. 19, 2010); *See,also, Antilla v. L.J. Altfest & Co.,* 2012 U.S. Dist. LEXIS 116294, 27, 2012 WL 3580477 (D. Conn. Aug. 17, 2012) ("In cases of professional negligence involving 'technical expertise **beyond the ordinary knowledge and experience** of jurors and **judges**,' expert testimony is required in order to prove professional negligence."); *In re Puda Coal Secs., Inc.,* 2014 U.S. Dist. LEXIS 83138, 41 (S.D.N.Y. June 17, 2014) ("In accounting malpractice cases, in which a mere negligence standard could be sufficient to establish liability, expert testimony is typically required.").

[11] For example, it is unclear whether the Division asserts that Delaney negligently breached a duty to prevent the violations, a duty to take action if he knew of the violations or some other purported duty.

differently; and (c) offered in-depth evidence of all of the issues he dealt with and was dealing with at the time of important events in the Division's timeline.

A. Expert Testimony.

Had he had notice of the Division's intent to advance a theory of negligence, Delaney would have sought and introduced evidence of the standards of care required from CCOs.

i. Withdrawn Expert Testimony

Delaney originally offered expert testimony of Greg Florio, a long-time CCO and compliance consultant. However, Florio's report which also constituted his direct testimony was withdrawn, in part because the evidence and legal theories advanced by the Division to that point in the Final Hearing made many of Florio's conclusions irrelevant to the resolution of the case. Florio was the only expert who even partially articulated the standard of care for a CCO. But he did not conduct a comprehensive analysis of the reasonableness of Delaney's conduct as CCO. Rather, Florio's report was focused only on the narrow reasonableness of Delaney's conduct with regard to transactions subject to Rule 204, not a comprehensive review of those transactions in the context of all of his responsibilities as CCO at PFSI. Had the Division provided notice that it intended to advance a theory of recklessness, Delaney would not have withdrawn Florio's testimony and would have sought a more comprehensive opinion from Florio regarding Delaney's conduct as CCO.

ii. Additional Experts

Delaney originally consulted with additional experts who could have offered opinions and briefly retained one additional expert, Marc Menchel, who was General Counsel and Executive Vice President of FINRA as well as having years of compliance industry experience.[12] After consultation with Mr. Menchel and a joint review of the OIP, Delaney and Menchel

[12] Should the Court find it necessary to verify this assertion, Delaney can provide a copy of the retainer letter.

concluded that Menchel's testimony was not necessary because the OIP concerned only intentional misconduct by Delaney and because expert testimony on standards of care would not be helpful to rebut claims of intentional and knowing assistance to violations.

Had the OIP alleged negligence, however, Menchel's experience as a CCO would have allowed him to offer credible testimony about the challenges of being a CCO in a complex firm such as PFSI. Further, his credentials as General Counsel of FINRA would have allowed him to offer testimony about the FINRA exam process and what is expected of FINRA members in the exam process. Menchel's industry experience would have given him the basis to offer relevant opinions about OCIE exams as well.

Delaney also consulted with Mike Nolan. Nolan was a compliance consultant and expert who was hired to audit the compliance department shortly after Delaney left. Nolan has both technical expertise and actual knowledge of the state of compliance at PFSI. He would have been uniquely positioned to offer an opinion that Delaney's efforts at PFSI were reasonable and consistent with the standards of care expected by a CCO.

Menchel and Nolan are two examples of experts whose testimony would have been offered if Delaney knew the Division would advance a theory of liability based on negligence.

iii. Presentation of Expert Testimony

In addition, had Delaney been provided notice that the Division would be proceeding on a negligence basis, he would have had his compliance expert(s) present throughout the hearing so they could base or adjust their opinions to reflect the testimony and evidence actually elicited at the hearing.

B. Cross Examination.

The Division has attempted to use the testimony of witnesses including Brian Gover, Holly Hasty and Yancey's expert Judith Poppalardo, to piece together a standard against which they judge Delaney's conduct as CCO. For example, the Division discussed in its closing brief that PFSI often had meetings when new rules came out but that Delaney did not recall a meeting related to the implementation of Rule 204.[13] Because these issues were not relevant to the theory of actual knowledge articulated by the Division in the OIP or its opening brief, Delaney did not have any motive to dedicate time cross examining witnesses on this topic.

Had the Division given Delaney notice of its intent to rely on a negligence theory, he would have asked multiple witnesses different questions. For example, Delaney would have asked at least Gover, Hasty, Yancey, McCain, and Pendergraft the following questions:

1. During your time in the industry, have you had the chance to work with and observe other CCOs?
2. What was your understanding of Delaney's duties as CCO at PFSI?
3. Did you understand Delaney's duties not only as they relate to Rule 204 but as they related to the entire compliance department?
4. Aside from Reg SHO, what compliance priorities were you aware that Delaney was responsible for as CCO?
5. Do you have any idea of how much of Delaney's time was dedicated to each of these compliance priorities?
6. Were you aware of how the relative priority of each of these compliance issues to regulators from OCIE and FINRA? Do you have an opinion based on the extent of their inquiries on how the Rule 204 inquiries compared in importance and focus to the other issues Delaney was addressing in his role as CCO?
7. Describe whether Delaney delegated authority for any of these compliance priorities and what steps, if any, you understood that Delaney took to supervise and oversee the work of those to whom Delaney delegated responsibility?
8. Were you able to observe Delaney's performance of these duties and the manner in which he addressed these compliance priorities during the time he served as CCO of PFSI?

[13] Division's Post-Hearing Brief at 18; *see also*, Division's Findings of Fact 129, 130, and 131 and associated evidence.

9. Did you ever have any concerns about the competence, professionalism, integrity, or effectiveness of Delaney's performance of his duties as CCO?
10. Were you ever concerned with the way in which Delaney performed his duties as CCO during his tenure at PFSI?

These questions would have elicited evidence that Delaney had substantial responsibilities as CCO, that some of the compliance challenges at PFSI were higher priorities than the Rule 204 issues both to PFSI and to its regulators, that he took steps to appropriately delegate responsibility for some of those compliance functions, that he oversaw those to whom he delegated, that Delaney addressed these issues to the best of his ability and that he did so with the care that they would have expected from an ordinary CCO based on their observation of other CCOs in the industry.

C. Additional New Evidence.

Had the Division provided notice of its intent to claim that Delaney had acted negligently, Delaney would also have presented additional evidence of all of his responsibilities as CCO at PFSI, including with respect to the response to new regulatory enactments, and his discharge of these duties. For example, during Delaney's testimony, he was asked about other topics in Exhibit 89, the response to FINRA in March, 2011.[14] In a negligence case all of these compliance issues may have been relevant to judge the reasonableness of Delaney's discharge of his duties as CCO of PFSI. Consequently Delaney would have offered testimony of the factual basis for each of these regulatory inquiries, his responses to them, and evidence of the relative priority of these issues to PFSI's regulators

CONCLUSION

Based on the reasons stated, the Court should not consider, and/or should reject, the Division's unpled and untimely theories.

[14] Tr. 1286:24 – 1296:3.

DATED this 27th day of January, 2015.

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January 27, 2015

Via Federal Express

Lynn M. Powalski, Deputy Secretary
Office of the Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Mail Stop 1090
Washington, D.C. 20549

RE: *In the Matter of Thomas R. Delaney II and Charles W. Yancey,* Administrative Proceeding File No.: 3-15873

Dear Ms. Powalski:

Enclosed please find the original and three copies of Thomas R. Delaney II's Response to the Court's Order dated January 23, 2015.

By copy of this letter, I have served all parties of record. If you have any questions or need additional information, please do not hesitate to contact our office.

Sincerely,

CLYDE SNOW & SESSIONS

Aaron D. Lebenta

Encls.

cc: Honorable Jason S. Patil, Administrative Law Judge, U.S. Securities and Exchange Commission (via email)
Polly Atkinson, Division of Enforcement, U.S. Securities and Exchange Commission (via email)
Sarah S. Mallett, Haynes and Boone, Counsel to Yancey (via email)